Dispatches from the mania

The interest-rate news streams by. You become numb to it. We present the following recent headlines—each plucked from Bloomberg unless otherwise noted—as a prod to re-sensitization. Bond bulls or bears, we are living in historic times. Savor the zaniness.

“U.S. 30-Year Bond and S&P 500 Relationship at Extreme” —Arbor Quantitative Analytics, July 11

“Valvoline’s Junk-Bond Deal Leaves Investors Clamoring for More,” July 14

“Surreal Negative-Rate Swap Sees Fortress REIT Paid to Fix Costs,” July 14

“Bond ETF funds attract $73 bn this year”—Financial Times, July 18

“ECB Fast Exhauising German Bonds for QE Buying as Yields Tumble,” July 19

“Corporate debt seen ballooning to $75 trillion: S&P”—CNBC.com, July 20

“Debt Issuance Can’t Keep Up With the ECB’s Hunger for Bonds,” July 21

“When Central Banks Rule the World, Utility Bonds Make 30 Percent in a Month,” July 21

“Nippon Life Buys France, Belgium Debt Amid Negative Japanese Yields” (French 15-year debt yielded 0.548%; Belgium’s 15-year debt, 0.591%), July 21

“Hot Money Fleeing Negative Yields Shelters in Outer Mongolia,” July 21

“Negative Yields Infecting Credit Markets as Investors Capitulate,” July 21

“China Sells 30-Year Government Bonds at Lowest Cost Since 2008,” July 22

“Japanese Splurge on Foreign Bonds as U.S. Yields Near Record Low,” July 22

“Draghi’s Sopping Up Whatever Liquidity Was in European Credit,” July 22

“Risk-parity managers say they can live with bond bear market,” Pension & Investments, July 25

“Yield Stampede Sends Emerging Bond Flows to Fresh Record,” July 25

“Beware the $10 Trillion Glut of Treasuries as Big Deficits Loom,” July 25

“Even Record Bond Defaults Can’t Stop China Yield Hunters’ Buying,” July 25

“It’s Not a Search for Yield but a Scramble for Safety,” July 26

“Japan’s 40-Year JGB Auction Draws Weakest Demand Since October,” July 26

And, finally, atop a July 22 Financial Times personality profile of the incoming chief of Pimco, the world’s largest bond manager, ran the headline: “Manny Roman’s career is a case study in impeccable timing.”

Ultimate hedge

Passive people may be nonassertive, but passive investors are another breed of cat. They are out to conquer the world, to judge by the inflows into Vanguard and its ilk over the past 12 months ($229 billion into passively managed funds, according to Morningstar, just shy of the $236 billion removed from actively managed funds). The tribulations of the active spirits, especially hedge funds, is the subject at hand—that and a revisit to a 21st-century monetary hedge.

We write with close attention to a new essay by the protean Murray Stahl, chairman, chief executive officer and chief investment officer of Horizon Kinetics and publisher of The Devil’s Advocate Report Compendium. Stahl’s essay in the new edition falls under the headline, “Interest rates, hedge funds and the rise of the artificial asset class.” Cryptocurrency is that asset class.

For reasons best known to themselves, the market gods have cast a plague on hedge funds. Or should we say “hedged” funds, as did the progenitor of the type, Alfred Winslow Jones, in the 1950s and 1960s? Jones would go long the stocks he liked and short the ones he didn’t. The sum of these positions would represent more than 100% of his capital, with margin debt financing the increment. A management fee of 1% and a performance fee of 20% would compensate the intrepid manager.

(Continued on page 2)
It paid to be hedged in a world of free and upstanding interest rates. You would sell short a stock and invest the proceeds in, say, an 8%-yielding Treasury bill (an actual yield as recently as August 1989). You, the hedged investor, would keep six percentage points, your prime broker, two. Think of it: You were ahead of the game by 6% even before your painstaking security analysis began to bear fruit.

How different it is today, Stahl reflects. As money-market interest rates do not actually exist, neither do short-sale rebates. On the contrary, you pay to procure the borrowed shares with which to implement a hedge. And as for the work you have devoted to security selection, the algorithmic traders heartily thank you for it. Ever alert to successful trading patterns—like the one that you have independently conceived—they will beat you to the execution punch every time.

Tiny interest rates present a multifaceted dilemma for the hedged investor. E-Z credit prolongs the lives of failing companies that the forces of creative destruction would otherwise put out of business. And if, even in this time of record-low yields, a failing company can’t raise a loan, a creditworthy acquirer might buy the weakling. And if no such buyer steps forward today, the bulls may hope (the bears dread) that one will materialize tomorrow. In short, hedged investing is hazardous business when central bankers rule the world.

And as with companies, so with currencies and sovereign debt: They stay afloat on the water-wings of cheap debt. “For instance,” Stahl observes, “the creation of the European Union, the European Central Bank and the euro were intended to prevent a repetition of the history of the Banca D’Italia funding the chronic deficits of the Republic of Italy with money creation and the endless depreciation of the Italian lire [sic]. Now the euro is in danger of resembling the Italian lire.”

And yet, Stahl marvels (as do we and so may you), the owners of $12 trillion of sovereign debt are willing to pay the respective borrowing governments for the privilege of lending them money. Which singular facts lead Stahl to cryptocurrencies, especially Bitcoin, of which there will finally be no more than one: 12,000,000,000 (a number which there will finally be no more than 12 billion coins of any kind), the owners of $12 trillion ofFacebook accounts. It’s a 45-degree line. Literally a straight line.

Writing about the assymetric possibilities of wonk-money, Stahl sounds a lot like Wences Casares, the Argentinaborn Bitcoin pioneer who addressed the fall 2015 Grant’s conference. Yes, Casares acknowledged, Bitcoin could become worthless; the odds of a wipeout he judged to be one in five. Then, again, there was a greater chance of Bitcoin coming into its own—30,000 people were buying their first coins every day. As Casares spoke, the price was $250 per crypto-coin. It is $656 today.

“A purchase of Bitcoin, however small,” Stahl proposes, “is nothing other than a short sale of the currencies of the world. It should be obvious that if it were to gain the confidence of a meaningful number of investors, it would not trade at a market capitalization of $9 billion [$10.3 billion as we go to press].

When Stahl sat down to write, just $10 trillion of sovereign debt was quoted at negative yields. “If Bitcoin were simply to be equal—via market demand—to the value of all government bonds with negative yields, the increase in value would be 1,111.11 times,” he continued.

Now, then, “if a portfolio having a 1% position experiences a 1,111.11 times appreciation in that position, the portfolio increases by .01 multiplied by 1,111.11, or 11.11 times. If this occurs over a five-year time period and if the price of every other position remains unchanged, this would be the equivalent of a 64.68% annualized rate of return. But that’s hardly impressive enough: If all other investments were to become worthless during this hypothetical time period and no dividends or interest were collected on any position, this portfolio’s rate of return would decline to 61.86%. Talk about a hedge!”

It’s a heartening sign, said Stahl, that so many people are trying Bitcoin on for size—opening a digital wallet even if they put nothing inside it. “You can actually visualize this,” he tells colleague Harrison Waddill. “If you look at the blockchain wallet’s website, and look at the graph of blockchain wallets—if you just look at the graph without looking at the scale, it looks like the graph of Facebook accounts. It’s a 45-degree angle. Literally a straight line.”

Stahl, whose Polestar Fund manages $120.6 million, says that he owns a Bitcoin position of a little less than 1% of AUM. On a more conventional unconventional note, he adds that he owns a pair of precious-metals plays, too (Franco-Nevada and Silver Wheaton). “I just felt like I wanted to diversify into something which is entirely different.”

Corporate mystery meat

Kerry Group plc (KYG in Dublin), a worldwide gastronomic giant in flavors, ingredients and packaged foods, is Ireland’s fourth-largest company by market cap. Don’t be chagrined if you’ve never heard of it. The stockholders don’t know much about it, either.
"Sell Big Food," exhorted the March 25 edition of Grant's in a reference to the fast-rising shares of Kraft Heinz Co. (KHC on the Nasdaq) and Campbell Soup Co. (CPB on the Big Board). Kerry, a top supplier to the packaged-foods industry, is just as overvalued as its big-name customers, in our opinion.

Kerry makes and markets emulsifiers, texturants, enzymes, proteins, hydrocolloids and fermented products. They infuse and flavor the kinds of packaged foods and beverages that the stock market seems to crave more than on-trend shoppers do. Taking the shoppers' part, we remain bearish on Kraft Heinz and Campbell. We are newly bearish on Kerry, a black box of an acquisition machine whose earnings do not make up for in quantity what they lack in quality.

Kerry Group, with €13.4 billion ($14.7 billion) of market value and €6.1 billion of 2015 revenue, was founded in 1972 as a joint venture of the Eric Casein Co., the Irish state-owned Dairy Disposal Co. and a federation of dairy cooperatives. Only for so long was the new creation content to hew to the legacy business of extruding protein from raw milk. By the early 1980s, it was diversifying out of dairy products. In 1986, it went public. The cows became financialized.

Ingredients, via Kerry's taste and nutrition division, delivered 76% of last year's sales (the company reports semiannually, so the most recently available results come from fiscal 2015). Packaged foods—Cheetstrings, LowLow, Dairygold, Bisto, among other brands of cheeses, meats and frozen meals, sold principally in Ireland and the UK—chipped in 24%.

The Americas account for half of ingredient sales. Europe, the Middle East and Africa (33%) and Asia-Pacific (17%) furnish the rest. The United States is Kerry's single most important market and contributed 39% of taste and nutrition revenues in 2015. Top ingredient end markets are beverages (24% of the division's sales), meats (18%), dairy (9%), bakery goods (9%), cereal and bars (6%) and soups, sauces and dressings (6%).

Kerry grows by acquisition. It has closed on 160 transactions since 2000, at a cost of €4.6 billion; in 2015 alone, it spent €893.2 million. Over this acquisitive decade and a half, top-line growth has averaged 5.8% per annum. Bottom-line growth, as measured per share, has weighed in at 9.5% per annum.

One might have expected a bigger revenue bang for the euro. Then, again, Kerry has had to confront a competitive UK grocery market as well as dimming consumer interest in foods that come in cans, boxes or pouches. In consequence—and on account of Kerry's decision to exit lower-margin businesses—sales at the consumer-foods division have declined at a 1.8% annual rate since 2010. Over the same span, annual growth in sales in the taste and nutrition business has risen at a 6.7% rate.

Bulls contend that the painful adjustments in the consumer-foods business are old news and that better days lie ahead. “The primary reason that we are invested in Kerry is because of the taste and nutrition business,” Paul Moroz, a portfolio manager at Mawer Investment Management, Calgary, which owns shares in Kerry, tells colleague Evan Lorenz. “They have grown through acquisitions and created a supermarket of brands. If you are a big consumer-food company and you want to tweak the taste of any sort of product, you are really outsourcing a lot of that R&D to Kerry Group. One of the nice things about their business is it is dependent on innovation and competition. The more they are able to innovate and help the customer, the better they are going to do over time. The idea is that it is going to drive margins.”

You might turn to Kerry, for instance, to develop a coating for chicken pieces. You would want to be able to claim that said coating was all-natural and that it was gluten-free. You would want to make sure that it tasted good and that it wouldn’t stick to the side of a hopper. The strategy of selling complex solutions rather than individual products is the new, new thing in flavors and ingredients.

It’s this approach—a “holistic” approach—in which Kerry is invested for the future, says William Lynch, head of investor relations at Kerry. “We’ve built out a platform for that for the future. That’s our view for the long term. That’s what makes the model of what we are doing a little different. There is a degree of missionary work in this because it is different from

<table>
<thead>
<tr>
<th>Kerry Group plc</th>
<th>All figures in € millions except per share data</th>
</tr>
</thead>
<tbody>
<tr>
<td>Revenue</td>
<td>€6,104.9</td>
</tr>
<tr>
<td>Trading profit</td>
<td>700.1</td>
</tr>
<tr>
<td>Amortization</td>
<td>37.4</td>
</tr>
<tr>
<td>Non-trading items</td>
<td>(9.4)</td>
</tr>
<tr>
<td>Operating profit</td>
<td>672.1</td>
</tr>
<tr>
<td>Interest expense</td>
<td>(69.3)</td>
</tr>
<tr>
<td>Profit before taxes</td>
<td>602.8</td>
</tr>
<tr>
<td>Taxes</td>
<td>77.4</td>
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<tr>
<td>Net Income</td>
<td>525.4</td>
</tr>
<tr>
<td>Shares outstanding (mns)</td>
<td>176.1</td>
</tr>
<tr>
<td>EPS</td>
<td>2.98</td>
</tr>
<tr>
<td>Cash</td>
<td>236.4</td>
</tr>
<tr>
<td>Debt</td>
<td>2,049.9</td>
</tr>
<tr>
<td>Net debt</td>
<td>1,813.5</td>
</tr>
<tr>
<td>EBITDA</td>
<td>828.5</td>
</tr>
<tr>
<td>Net debt/EBITDA</td>
<td>2.2 x</td>
</tr>
<tr>
<td>Op. prof/Interest exp.</td>
<td>9.7</td>
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</tbody>
</table>

source: company reports
what is the traditional model of selling single ingredients.”

Kerry hardly has this market, or notion, to itself—Givaudan SA, the Swiss flavor and fragrance company, is always talking about “integrated solutions.” Just the same, according to Lynch, no competitor fields more than 25%–30% of the immense Kerry product line.

For Wall Street’s money, Kerry’s best flavor is its steady-eddy predictability. It loves Kerry as it loves Big Food (now, admittedly, after our analysis, Bigger Food) and for much the same reason. Safety, or rather, we should say, perceived safety, is what investors seem to crave. Thus, the Street is looking for increases of 2.8% and 4.7% in 2016 and 2017 revenue, along with corresponding rises of 7.5% and 11.4% in EPS. “In these uncertain times,” Ian Hunter, the analyst who covers Kerry at Investec Bank plc, tells Lorenz, “it is a company that is not going to surprise to the up- or the downside very markedly. You are not going to get profit warnings. It is going to keep providing a dividend although the yield at the moment is low. It is still higher than bond yields. It is just a safe bond proxy. That is why people are putting money into it. Whenever they see something crash, money comes back into this sector.”

To judge by Kerry’s stock price, investors must be especially furtive. KYG is quoted at 25.2 times 2015 earnings, at 23.4 times the 2016 estimate and at 18.3 times enterprise value (current market cap plus net debt as of Dec. 31) to trailing EBITDA. The shares yield all of 0.66%. Then, again, the Kerry triple-B-plus-rated, euro-pay senior unsecured 2/8s of 2025 change hands at 114.50 to yield 0.73%, not much more than the single-A-plus-rated Irish sovereign 10-year notes, which fetch 0.48%.

To the bulls, the Kerry stratagem is worth a premium valuation. Independent, niche ingredient-makers lack scale and a worldwide marketing platform. They gain both in the Kerry corporate fold. With a projected €1 billion in M&A outlays this year in their “upside” case, J.P. Morgan Cazenove analysts Alberto Lopez Rueda and Celine Pannuti advised their clients on April 28, Kerry would be able to retain its fancy multiple while generating 15% EPS growth in 2017.

“You’d expect that Kerry, as both a supplier to packaged-food companies and as a manufacturer of off-trend foods itself, would be struggling to deliver the kind of robotic, never-miss results that the Street demands,” Lorenz observes. “That it seems not to be struggling is a mystery that may owe as much to sparse disclosure as to substantive results. Peruse the income statement,” Lorenz proceeds, “and you’ll notice some key items missing, such as cost of goods sold (which is needed to calculate the company’s gross margin as well as working capital ratios like days inventory and days payable) or operating expenses. Instead, below the revenue line, investors are treated to a single line item called ‘trading profit,’ which is operating profits before the amortization of intangible assets, and ‘non-trading’ expenses, an opaque line item that typically includes restructuring- and acquisition-related expenses.

“This selective approach to disclosure is also evident on Kerry’s investor-relations website,” Lorenz goes on. “You can download and save to your computer the annual reports from 2011 through 2015. The 2010 annual? Available only ‘on request.’ While you can open PDFs containing the annual reports from 2008 and 2009, you cannot save these documents to your computer; the company disabled that feature.

“An industrious analyst,” Lorenz continues, “can peel down to the third footnote in the 2015 annual report to find some disclosure on operating expenses. Some line items in the note are easy to understand, e.g. ‘raw materials and consumables’ and ‘staff costs.’ Others are enigmatic, e.g. ‘other external charges’ and ‘other operating charges.’ In fact, to make sense of most line items on Kerry’s financials, a reader must excavate the information from footnotes.”

Lorenz took his complaints to Lynch, the IR man, who replied, inter alia: “When we would look at ourselves from a peer analysis from what we disclose for companies in this part of the world, we would see ourselves as being in the—we wouldn’t be behind the curve—we may not be at the top of the curve, but we are not behind the curve.”

Still—this is your editor speaking—it takes more than obfuscation to defeat Lorenz. He finds, upon digging into footnotes and tables, that sales to regions accounting for 65% of Kerry’s top line registered a 4.9% year-over-year decline last year. Ex-acquisitions and dispositions, sales to these markets—America, Britain and Ireland—would have fallen by 3.1%.

Asked to explain why, Lynch replied that sales are growing “on a volume basis.” Which would seem to suggest that Kerry is selling more products at lower prices. What differentiates the likes of Givaudan, Symrise AG, International Flavors & Fragrances, Inc. (IFF) and Novozymes A/S is their ability to sell fewer (or, if they choose, more) products at higher prices.

It’s in this commercially aristocratic cohort that the bulls would place Kerry. And, to be sure, the Kerry busi-
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bargain-basement equities, puffed-up equities,
inflation and its alternative.

Julian Robertson in conversation with Seth Klarman in conversation with
James Grant The Wall Street Journal’s Bret Stephens

Speakers

Marc Cohodes, former managing partner of Copper River Management
Martin Fridson, Lehmann Livian Fridson Advisors LLC
Simon Yoo, Green Visor Capital Management
Miguel Fidalgo, Triarii Capital Management
Jeffrey Gundlach, DoubleLine
Lacy Hunt, Hoisington Investment Management
Keith Ney, Carmignac
Steven Bregman, Horizon Kinetics

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Credit Creation

They asked for it

Short-term interest rates didn’t wait for the Federal Open Market Committee to confer (the mandarins met on Wednesday, after Grant’s went to press). They decided to go up on their own. On Monday, the king of money rates, three-month Libor (for London interbank offered rate) put in a post-crisis high of 73.4 basis points, up from 61.3 basis points at year-end and 29.4 basis points one year ago.

It is not quite correct to say that Libor leapt independently of the government. It was the regulators who wrote the rules that caused the spike. Institutional prime money funds—the kind that invest in certificates of deposit, commercial paper and repurchase agreements, as well as government-issue paper—must switch to floating net asset values by Oct. 14 (Grant’s, April 8). The feds seem to wish that the prime funds would dry up and blow away. The market is trying to discover the rate of interest that’s high enough to hold prime investors in place.

Since the start of the year, investors have pulled $275.6 billion from the prime funds, bringing their assets to $1.008 trillion, just about the lowest level since 1998. Government-only funds are the favorite destination for refugees from the private sector. They have seen assets swell by $297.3 billion since the start of the year to a record $1.518 trillion. Not only will the government-only

FEDERAL RESERVE BALANCE SHEET

(in millions of dollars)

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<thead>
<tr>
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<tbody>
<tr>
<td>The Fed buys and sells securities...</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Securities held outright</td>
<td>$4,240,111</td>
<td>$4,231,137</td>
<td>$4,244,822</td>
</tr>
<tr>
<td>Held under repurchase agreements and lends...</td>
<td>0</td>
<td>0</td>
<td>0</td>
</tr>
<tr>
<td>Borrowings—net</td>
<td>235</td>
<td>183</td>
<td>192</td>
</tr>
<tr>
<td>and contracts its other assets...</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Maiden Lane, float and other assets</td>
<td>198,935</td>
<td>200,296</td>
<td>216,053</td>
</tr>
<tr>
<td>The grand total of all its assets is:</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Federal Reserve Bank credit</td>
<td>$4,439,281</td>
<td>$4,431,616</td>
<td>$4,461,067</td>
</tr>
<tr>
<td>Foreign central banks also buy, or monetize, governments:</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Foreign central-bank holdings of Treasurys and agencies</td>
<td>$3,228,447</td>
<td>$3,222,420</td>
<td>$3,340,353</td>
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</table>

PEOPLE’S BANK OF CHINA BALANCE SHEET

(in billions of renminbi)

<table>
<thead>
<tr>
<th></th>
<th>June 2016</th>
<th>May 2016</th>
<th>June 2015</th>
</tr>
</thead>
<tbody>
<tr>
<td>Foreign exchange and other foreign assets</td>
<td>Rmb 24,274</td>
<td>Rmb 24,380</td>
<td>Rmb 27,446</td>
</tr>
<tr>
<td>Gold</td>
<td>249</td>
<td>245</td>
<td>209</td>
</tr>
<tr>
<td>Claims on domestic economy</td>
<td>7,957</td>
<td>7,063</td>
<td>4,633</td>
</tr>
<tr>
<td>Other assets</td>
<td>1,335</td>
<td>1,340</td>
<td>1,419</td>
</tr>
<tr>
<td>Its assets total:</td>
<td>Rmb 33,814</td>
<td>Rmb 33,027</td>
<td>Rmb 33,708</td>
</tr>
</tbody>
</table>

MOVEMENT OF THE YIELD CURVE

Source: The Bloomberg
funds be allowed to maintain stable reported NAVs post the October deadline, but also they will enjoy the federally conferred privilege of imposing redemption fees or gates come the next crisis.

Regulation is shaking up the short-term funding markets in other ways that the authorities might not have planned on. Last week, JPMorgan Chase & Co. announced that it would exit the triparty general collateral financing (GCF) repo market by the end of 2017. No secret why. “Given bank regulation, daylight overdraft reform, tri-party reform, increased business complexity, client default risk, etc., the business has become increasingly expensive,” relates Wedbush Securities managing director Scott Skyrm.

This will leave Bank of New York Mellon Corp. as the sole intermediary in what has become a $275 billion market. Any problems that Mellon runs into—software glitches, Russian hackers, financing troubles—will likely infect the broker-dealers that rely on GCF repo funding.

“A few more competitors (like BMO Harris, State Street, and Citi) would help the market,” Skyrm concludes. “However, there’s still the issues of expenses and regulation, if clearing represented a profitable opportunity, we would certainly see other banks lining up to get in.”

Back over to you, federal overseers.

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**Credit Creation**

• **Cause & Effect**

They asked for it

**ANNUALIZED RATES OF GROWTH**
(latest data, weekly or monthly, in percent)

<table>
<thead>
<tr>
<th></th>
<th>3 months</th>
<th>6 months</th>
<th>12 months</th>
</tr>
</thead>
<tbody>
<tr>
<td>Federal Reserve Bank credit</td>
<td>-1.1%</td>
<td>-0.8%</td>
<td>-0.3%</td>
</tr>
<tr>
<td>Foreign central-bank holdings of gov’ts</td>
<td>-3.0%</td>
<td>-3.9%</td>
<td>-3.8%</td>
</tr>
<tr>
<td>People’s Bank of China</td>
<td>15.4%</td>
<td>13.2%</td>
<td>0.3%</td>
</tr>
<tr>
<td>Commercial and industrial loans (June)</td>
<td>7.9%</td>
<td>11.2%</td>
<td>9.6%</td>
</tr>
<tr>
<td>Commercial bank credit (June)</td>
<td>7.3%</td>
<td>7.6%</td>
<td>7.2%</td>
</tr>
<tr>
<td>Asset-backed commercial paper</td>
<td>-33.9%</td>
<td>-9.6%</td>
<td>5.0%</td>
</tr>
<tr>
<td>Currency</td>
<td>5.5%</td>
<td>6.1%</td>
<td>6.8%</td>
</tr>
<tr>
<td>M-1</td>
<td>11.6%</td>
<td>10.3%</td>
<td>7.7%</td>
</tr>
<tr>
<td>M-2</td>
<td>7.4%</td>
<td>8.1%</td>
<td>6.8%</td>
</tr>
<tr>
<td>Money zero maturity</td>
<td>7.6%</td>
<td>7.8%</td>
<td>6.7%</td>
</tr>
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</table>

**REFLATION/DEFLATION WATCH**

<table>
<thead>
<tr>
<th></th>
<th>Latest week</th>
<th>Prior week</th>
<th>Year ago</th>
</tr>
</thead>
<tbody>
<tr>
<td>FTSE Xinhua 600 Banks Index</td>
<td>12,434.67</td>
<td>12,507.52</td>
<td>14,223.86</td>
</tr>
<tr>
<td>Moody’s Industrial Metals Index</td>
<td>1,582.94</td>
<td>1,561.38</td>
<td>1,560.79</td>
</tr>
<tr>
<td>Silver</td>
<td>$19.69</td>
<td>$20.17</td>
<td>$14.70</td>
</tr>
<tr>
<td>Oil</td>
<td>$44.19</td>
<td>$45.95</td>
<td>$48.45</td>
</tr>
<tr>
<td>Soybeans</td>
<td>$10.07</td>
<td>$10.73</td>
<td>$10.10</td>
</tr>
<tr>
<td>Rogers Int’l Commodity Index</td>
<td>2,252.65</td>
<td>2,252.65</td>
<td>2,499.61</td>
</tr>
<tr>
<td>Gold (London p.m. fix)</td>
<td>$1,320.75</td>
<td>$1,327.00</td>
<td>$1,097.40</td>
</tr>
<tr>
<td>CRB raw industrial spot index</td>
<td>459.70</td>
<td>460.86</td>
<td>448.21</td>
</tr>
<tr>
<td>ELC Future Inflation Gauge</td>
<td>(June) 111.4</td>
<td>(May) 110.5</td>
<td>(June) 101.2</td>
</tr>
<tr>
<td>Factory capacity utilization rate</td>
<td>(June) 75.4</td>
<td>(May) 74.9</td>
<td>(June) 78.4</td>
</tr>
<tr>
<td>CUSIP requests</td>
<td>(June) 1,564</td>
<td>(May) 1,676</td>
<td>(June) 1,564</td>
</tr>
<tr>
<td>Fed’s reverse repo facility (billions)</td>
<td>44.9</td>
<td>41.2</td>
<td>116.5</td>
</tr>
</tbody>
</table>

*Grant’s Story Stock Index* 111.67 112.26 109.27

*Grant’s Never-Never Index* 213.96 210.09 185.87

**EFFECTIVENESS OF THE MONETARY POLICY**

M-2 and the monetary base (left scale) vs. the money multiplier (right scale)
ness portfolio does contain some of the moated products in which it is possible to raise prices. According to an insider’s estimate (by Frutarom Industries Ltd., a Haifa, Israel–based flavor and fragrance business), as much as a fifth of Kerry revenue sources might answer the description of “differentiated.” However, the remaining 80% would seem to put Kerry more properly in the company of the producers of commodity-like packaged-food ingredients such as Tate & Lyle plc, Koninklijke DSM NV and Corbion NV. There’s nothing so exotic about V8 vegetable juice, or even V-Fusion Smoothie Mix, which product, for instance, Kerry scooped up in its September acquisition of Island Oasis.

As you might expect, upper-echelon companies post above-average profit margins. To earn them, they commit to above-average research and development spending. Thus, on average in 2015, Givaudan, Symrise and IFF generated an average EBITDA margin of 22.9% and spent an average of 7.7% of sales on R&D. Compare and contrast Tate et al., which produced an average EBITDA margin of 13.5% and earmarked 3% of sales for R&D.

Kerry’s vital signs—EBITDA margin of 13.6% and R&D outlays equivalent to 3.8% of sales—place it squarely in the Tate cohort.

“In fact,” Lorenz observes, “the principal way in which Kerry resembles high-end flavor companies is valuation: The trio of more differentiated companies trade at an average of 17.2 times enterprise value to EBITDA, while Kerry trades at 18.3 times. As for the less differentiated trio, they’re quoted at 11.7 times.”

Kerry treats its acquisitions almost as if they were state secrets. Are you curious about post-acquisition accounting adjustments? The front office has vouchsafed details on only one of last year’s 10 company purchases (that of Red Arrow Products, a Manitowoc, Wisc., maker of smoke flavors for meats). It lumped the other nine together like so much pizza dough.

Analysts should count themselves lucky that management saw fit to disclose the fact that newly acquired businesses contributed €133 million to revenues in 2015. Concerning the €121.5 million of acquisitions completed in 2013, the C-suite sounded as if it were too tired to convey the relevant facts: “Due to the rapid integration of the acquired businesses into the Group’s current structure, involving all aspects of business activities such as manufacturing, commercial, finance and IT, separate disclosure of the acquisitions’ revenues and profit or loss is impracticable.”

In the way of roll-ups, Kerry assigns most of its purchased assets to goodwill and intangibles to minimize the impact of the new accessions on the income statement (c.f. Grant’s, June 17). In 2015, it so classified €786.6 million of the aforementioned €893.2 million spent on acquisitions.

There is some reason to think—Lynch himself suggests it—that American, British and Irish sales are more profitable than the ones that Kerry is booking in more rapidly growing markets. Sales to parts of the world excluding America, Britain and Ireland rose by 10% in 2015 (after adjusting for the impact of currencies, acquisitions and disposals). Curiously, Kerry’s reported profit margin reflects none of the diminution that that observation implies. Trading margin, i.e., trading profits divided by sales, has risen, not dwindled: to 11.5% in 2015, from 11.1% in 2014 and 10.5% in 2013.

No such improvement is evident in the quality of earnings. In 2012 and 2013, Kerry generated EPS of €1.48 and €0.48 a share, respectively. That was according to International Financial Reporting Standards, the global GAAP. Better, management suggested, to focus on adjusted earnings that exclude those unsightly expenses. Between 2012 and 2013, adjusted EPS rose to €2.58 from €2.34.

Big acquisition-related restructuring charges were responsible for the IFRS-calculated drop. The charges led to the buildup of provision accruals on the balance sheet. The release of those charges—in the sums of €53.5 million and €11.1 million, respectively, or €0.26 and €0.05 a share—gave a filip to IFRS-reported earnings in 2014 and 2015.

Asked about those releases, Lynch replied that Kerry embarked on a restructuring program in 2012 and 2013. He continued: “We wanted to provide [provisions] to keep it clear and, particularly, as we were coming out of 2014, we didn’t want any non-trading items [i.e., restructuring charges] in our figures thereafter because it was a two-year program.”

Only the most assiduous students of Kerry’s finances understood what was going on—the information was secreted in footnote 25 of the annual report. It makes you wonder what other riches the fastness of the fine print might conceal.

The corporate tax rate is another source of confusion and, indeed, mystery. In 2015, Kerry paid a rate of 12.8%. Ireland, Kerry’s home, is a famously low-tax jurisdiction, but
Kerry makes most of its products in the countries in which it sells them. The United States, Kerry's top market, is a famously high-tax jurisdiction. One might therefore expect a bigger tax bite than the one which Kerry reported.

"Be that as it may," Lorenz notes, "the company’s cash tax rate has conventionally tracked the company’s accrual tax rate. In other words, the tax information on the statement of cash flows has customarily squared up with the tax information presented on the P&L. Thus, in the years 2011, 2012 and 2013, the cash tax rate was within a couple of percentage points of the accrual tax rate. The pattern was broken in 2014 and 2015 when the cash tax rate was just 40% and 49% of the accrual rate, respectively."

In reply to Lorenz’s query, Lynch said that the enigma can be explained by “the investments we have in terms of the global technology innovation center that we’ve rolled out in terms of Ireland which has been a €100 million investment.” He added that, “Over time you will see the cash tax and the effective tax converge again. It is a timing effect.” Beyond us is how such a sizable dip in the applicable corporate tax rate can be ascribed to an investment in the country in which Kerry books only 7% of its sales.

All you really need to know, a bull might say, is that Kerry generated a record €469.1 million in free cash flow in 2015 (that is, cash flow from operations less capital expenditures). To which we might say, that achievement may not be all it seems. From 2000 through 2014, Kerry spent billions on acquisitions, yet free cash flow stubbornly refused to grow, averaging €230.7 million; it ranged between €111.2 million in 2001 and €352.8 million in 2009. What accounts for the 2015 blowout is the aforementioned low cash tax rate and a seemingly minor €64.8 million reduction in working capital.

“There was, in fact,” Lorenz relates, “a €144.1 million swing from the €79.3 million that working capital consumed in 2014. Footnote 29, which breaks the line item ‘change in working capital’ found in the cash flow statement, raises more questions. The note states that, in 2015, inventories fell by €45.4 million and trade and other receivables rose by €11.2 million. According to the balance sheet, inventories rose (not fell) by €32.2 million and trade and other receivables rose by €32.8 million in 2015. The acquisitions Kerry bought for €893.2 million in 2015 may explain the anomalies in cash flows, but they raise further questions about earnings quality.

“In sum,” Lorenz closes, “Kerry is increasingly reliant on acquisitions to compensate for sales declines in the core business and on earnings gimmicks to meet consensus estimates. Apropos of the bulls’ conviction that no earnings restatement is likely or even conceivable, we will have to wait and see. New sets of eyes will be reviewing Kerry’s books beginning in 2016. In is PricewaterhouseCoopers. Out is Deloitte, Kerry’s auditor since 1986.”

In March, insiders sold a net 77,523 shares of Kerry for €6.1 million in proceeds. It was the only insider activity in the preceding 12 months. An informed signal, we judge.

- Speculating for income

There’s no investment income to be had. That is the fact. At least, there’s none that answers the description of natural, organic, unleveraged and secure. For U.S. dollar-denominated yields in excess of, say, 3%, one must settle for the hothouse variety of yield, the kind grown in debt.

So income-producing gimmicks are the items on the agenda. The securities under review are the types once known as a businessman’s risk—you pay your money, you take your chances. Each affords some protection against rising rates. We are willing to forego protection against falling rates. They have been slipping for 34 years and 10 months.

Benjamin Graham and David Dodd described bond selection as a “negative art.” As the upside in fixed-income investing is inherently limited, one must bank on the downside. We take the great thinkers’ counsel to heart. What’s wrong, not what’s right, is a running theme of the essay now in progress.

What’s wrong with bonds today is the frenzy to own them. Conveniently, you can trade the concept of What’s Wrong with Bonds in a liquid ETF. The iShares International Treasury Bond ETF (IGOV on the NASDAQ exchange), heavy-laden with Japanese government debt, is that security, and it yields a princely 0.17%. And wouldn’t you know that it’s returned 9.9% in the year to date (not, principally, from coupon income)?

“Investors are buying bonds for capital appreciation and stocks for income,” sagely observes James Abate, chief investment officer at Centre Asset Management (he was so quoted in a July 11 MarketWatch story). “The world has turned upside down.”

Will it ever turn rightside up? Janu-
ary 2017 puts on IGOV are quoted at a $98 strike; they’re priced at $3.30 with an implied volatility of 10.3%. The put-holding bond bear would make money if the shares, now quoted at $98.46, traded below $94.70. They began the year at less than $90.

But we were talking about income. In the Grant’s spotlight are fixed-to-floating bank-issued preferred shares, a mortgage real-estate investment trust specially attuned to the risk of rising rates, a commercial mortgage REIT and a certain closed-end bond fund. Not one could be confused with a long-dated 6% Treasury bond, which, as you will have noticed, happens not to exist.

Fixed-to-floating preferreds pay semiannual dividends. The payouts are discretionary, non-cumulative and subordinated to the other interest owed by the issuing institutions, among which are four American money center banks. The preferreds are usually callable, even if nominally perpetual. The call date is typically five or 10 years after the IPO.

For instance, JPMorgan Chase’s 7.9% Series I perpetual callable preferreds (trading over-the-counter under the CUSIP 46625HHA1) pay that 7.9% dividend every six months until the April 2018 call. If uncalled on April 30, the shares start paying quarterly dividends based on a rate of Libor (currently 0.73%) plus 3.47%.

Many preferreds are quoted on the Big Board in dollar amounts rather than relative to par (usually a $25 par for listed shares). The Morgan issue has a par value of $1,000. It’s quoted on Bloomberg at a “clean price” of 103.97 to yield 5.5% to call. Thus, a single preferred share would cost the buyer $1,039.70 before accrued interest. After accounting for progress toward the next dividend date, the price would ratchet up to $1,059.22.

Preferreds are the red-headed step-children of a capital structure. They rank senior only to the equity, and the ratings agencies judge them a notch or so inferior to their parent’s creditworthiness. While JPMorgan Chase carried a long-term issuer rating of A-minus, the 7.9% preferreds are appraised triple-B-minus (by S&P in both cases).

“You can get a current yield close to 6%,” a fan of the preferreds, speaking of the fixed-to-floating field in general, tells colleague Alex Hess. “And if inflation goes up and rates go up, that fixed-to-floating feature protects them—as long as the lift-off is not so quick and powerful as to induce a call. Libor, back before the Fed raised the funds rate for the first time, was selling at 0.24%;” our aficionado continues. “Once they raised, it shot up and now it’s at 0.73%. Conceivably, we’ll be looking at a Libor rate in four years of at least 2%.” Add that to a typical spread above Libor that the preferred shares pay, and you have a floating-rate instrument that yields upwards of 6%.

Adverse outcomes are easy to imagine. Rates might fall, not rise. Or rates might rise too fast. As to the latter possibility, imagine that the preferred holders get their long-awaited upside lurch in rates and inflation. “Imagine,” Hess adds, “that Libor reaches 7%. The JPMorgan Chase Series I preferred holders, once content with their 7.9% coupon, are ecstatic—their yield is set to rise to Libor plus those 347 basis points, or to 10.47% per annum. The bank’s funding costs shoot up, too, even faster than the yield on its assets. Come the April 2018 call, JPM elects to rid itself of its most expensive capital and trains its eyes on that very preferred.”

At this point, the preferred holders are kicking themselves not once but twice, as they have missed a wonderful rally in bank stocks—that is, the common stocks. In 2009, net interest margins for FDIC-insured institutions averaged 3.49%. By the first quarter of 2016, that average had dwindled to 3.10%. The deterioration is duly reflected in the performance of bank equities. While the S&P 500 has climbed by 6.1% this year, the bank component of the S&P index has fallen by 8.9%. Bank of America and Citi change hands at double-digit percentage discounts to book value. BofA, Citi, JPM and Wells Fargo are quoted at between eight and 12 times trailing net income; on average, the four yield 2.2%. Certainly, the share prices have room to run if rates rise and net interest margins fatten.

On, now, to Capstead Mortgage Corp. (CMO on the Big Board), a mortgage REIT constructed to weather a rise in interest rates. The trouble is that mortgage rates have not risen (though Libor has), and Capstead has cut its quarterly dividend three times, to 23 cents a share from 34 cents a share, since the end of 2014. In 2011, the company was earning an interest margin on its mortgage portfolio of 168 basis points. At last report (there was be an update on July 27, the day after we went to press), that spread had shriveled to 90 basis points.

When we last looked in on the company (Grant’s, Feb. 12), CMO was quoted at 81% of book to yield 11.2%, and Andy Jacobs, the long-serving CEO, was still at the helm. Jacobs and Capstead unexpectedly

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**Mr. Market changes his mind**

**Blackstone Mortgage Trust’s price-to-book ratio**

- 5/13: 1.15
- 5/14: 1.14
- 5/15: 1.11
- 5/16: 1.20

**price-to-book ratio**

- 0.85
- 0.90
- 0.95
- 1.00
- 1.05
- 1.10
- 1.15
- 1.20

**source:** The Bloomberg
parted company on July 14. The company declines to say anything more than that CFO Phillip Reinsch, who has been on the payroll since 1993, is running things now. Whatever the reason for Jacobs’s departure, the yield-hungry market has taken the news in stride. The shares are quoted at 89% of book value and yield 9.2%. Since the shakeup, they’ve actually managed a little rally. They are no longer a bargain, an observation with wide applicability these days.

Capstead bears risks common to all mortgage REITs. Thus, the company’s long-term capital of $1.4 billion supports assets of $14.1 billion, while the interest-sensitive American mortgagee can (and does) refinance whenever the arithmetic allows it (thereby depriving the investor of the mortgages that he or she would rather keep or, in a time of rising rates, sticking that investor with the assets that he or she would just as soon lose).

Complexity risk is another hazard of mortgage REIT investment. Capstead’s brand of adjustable-rate mortgages add a separate layer of complexity. ARMs do not reset as soon as rates rise; the elapsed time to reset varies. As of March, 58% of the company’s ARM portfolio was on course to reset in an average of 6.2 months, the remaining 42% in an average of 41.8 months. There are other moving portfolio parts, including the frequency at which rates reset and the movement in the interest rates against which the ARMs adjust. Nor should one overlook the risk that interest-rate hedges misfire. Such elements contribute to the sometimes volatile fluctuations in book value that make for mortgage REIT mal de mer.

For all its mechanical complexity, Capstead has given a good long-term account of itself. In the past 10 years, its shares have generated a total return of 16% a year, most of which stemmed from dividend income (out of 341.8 percentage points of total return, price movement contributed 43.1 percentage points). Annaly, the biggest mortgage REIT, produced annual 10-year returns of 11.4%, more than 100% of which stemmed from dividend income; the grand total price change over the period was minus 11%. A sustained period of rising rates would likely burnish Capstead’s record.

Blackstone Mortgage Trust (BXMT), a longtime Grant’s favorite among leveraged income-producing vehicles that are riskier than they seem, invests in senior commercial mortgages. It borrows at Libor plus 2% or so, invests at Libor plus 4/5% and manages to generate a trailing-12-month return on equity in excess of 10%. How? Why, debt: It uses a little more than $3 in financial leverage for every dollar of equity employed.

Blackstone admits it can’t compete with banks and insurance companies in lending to fully tenanted trophy buildings. It lends, instead, to the sponsors of buildings that have just lost a big tenant or are otherwise in transition. “If you take a 95%-leased building in Manhattan, they wouldn’t be able to compete for that,” says a knowledgeable source. “But if a 30% tenant left, and it became 65% leased, then a lot of lenders can’t handle that the current cash flow has been temporarily disrupted and isn’t reflective of its ultimate cash flows or ultimate value. And that’s where they come in.”

In exchange for the risk, Blackstone earns a higher rate than the banks and insurers do on their blueblood loans. Its goal is to lend no more than 65% of quoted real-estate value, another form of risk mitigation. At the end of the first quarter (we go to press just before release of second-quarter results), Blackstone’s $9.3 billion in mortgage assets was apportioned 45% to office buildings, 20% to hotels, 14% to manufactured housing. New York accounted for 21% of building value, followed by California at 13% and the United Kingdom at 11%. Floating-rate mortgages predominated, at 79% of the portfolio.

“Our credit facilities,” Steve Plavin, CEO, told dialers-in to the first-quarter earnings call, “are term-matched or long-term. They are currency- and index-matched, limited-recourse, and we have no capital-market space mark-to-market provisions.”

Then came Brexit. July 26 brought news of a 14% post-Brexit markdown in the value of a major residential development at Earls Court in Central London and of the forced offering (by Aberdeen Asset Management) of an office building in Hammersmith, West London. Maybe the second-quarter conference call, slated for July 27, has clarified Blackstone’s UK exposures.

BXMT has rallied along with everything else in the world. At 1.1 times book value, 12 times earnings and yielding 8.7%, the shares aren’t the bargain they were in February (Grant’s, Feb. 26). They are an OK speculation on yield in an unyielding market.

It happens that another Blackstone income-producing entity, the Blackstone/GSO Strategic Credit Fund (BGB on the Big Board), also yields in excess of 8% (8.5% to be exact). We’ll give this one wide berth.

BGB is a closed-end fund. As of the first quarter, senior secured loans filled 72% of its portfolio, junk bonds 26%. Borrowed funds were equivalent to 32.8% of net assets. The loans paid an average spread to Libor of 5.7%, the average bond coupon was 8.6%.

Credit risk is one thing, leveraged credit risk something very different. And leveraged credit risk—with a 20% exposure to high tech, no less—is what BGB has to offer. Nearly 30% of the fund’s assets were rated Caal or lower by Moody’s, according to material presented by the sponsor. Liquidity risks complement the others. To quote the BGB prospectus: “In general, the secondary trading market for senior secured loans is not fully developed…. To the extent that a secondary market does exist for certain senior secured loans, the market for them may be subject to irregular trading activity, wide bid/ask spreads and extended trade-settlement periods.”

Why would anyone partake? Basis points of income are the new grains of gold (soon to be supplanted, we expect, by the old grains of gold). The investment zeitgeist was neatly captured by the Financial Times in a July 21 story about the refusal of American investors to abandon the marginally higher-yielding money-market funds that the SEC is trying to regulate out of business.

“For now,” the paper reported, “the higher yields on prime funds are proving too tempting at a time when investors are keen for returns on their cash against a backdrop of near record-low interest rates.” Just how tempting? The so-called prime funds yield 0.27%; government funds, 0.16%. It’s a temptation in keeping with the treacherous times. Then, again, in which other times can we choose to live?
They asked for it

Short-term interest rates didn’t wait for the Federal Open Market Committee to confer (the mandarins met on Wednesday, after Grant’s went to press). They decided to go up on their own. On Monday, the king of money rates, three-month Libor (for London interbank offered rate) put in a post-crisis high of 73.4 basis points, up from 61.3 basis points at year-end and 29.4 basis points one year ago.

It is not quite correct to say that Libor leapt independently of the government. It was the regulators who wrote the rules that caused the spike. Institutional prime money funds—the kind that invest in certificates of deposit, commercial paper and repurchase agreements, as well as government-issue paper—must switch to floating net asset values by Oct. 14 (Grant’s, April 8). The feds seem to wish that the prime funds would dry up and blow away. The market is trying to discover the rate of interest that’s high enough to hold prime investors in place.

Since the start of the year, investors have pulled $275.6 billion from the prime funds, bringing their assets to $1.008 trillion, just about the lowest level since 1998. Government-only funds are the favorite destination for refugees from the private sector. They have seen assets swell by $297.3 billion since the start of the year to a record $1.518 trillion. Not only will the government-only funds be allowed to maintain stable reported NAVs post the October deadline, but also they will enjoy the federally conferred privilege of imposing redemption fees or gates come the next crisis.

Regulation is shaking up the short-term funding markets in other ways that the authorities might not have planned on. Last week, JPMorgan Chase & Co. announced that it would exit the triparty general collateral financing (GCF) repo market by the end of 2017. No secret why. “Given bank regulation, daylight overdraft reform, tri-party reform, increased business complexity, client default risk, etc., the business has become increasingly expensive,” relates Wedbush Securities managing director Scott Skyrm. This will leave Bank of New York Mellon Corp. as the sole intermediary in what has become a $275 billion market. Any problems that Mellon runs into—software glitches, Russian hackers, financing troubles—will likely infect the broker-dealers that rely on GCF repo funding.

“A few more competitors (like BMO Harris, State Street, and Citi) would help the market,” Skyrm concludes. “However, there’s still the issues of expenses and regulation, if clearing represented a profitable opportunity, we would certainly see other banks lining up to get in.”

Back over to you, federal overseers.

•

Thank the regulators

Three-month Libor

source: The Bloomberg
**Notice of Class Action Settlements**

If you transacted in Euroyen-Based Derivatives between January 1, 2006 through June 30, 2011, inclusive, then your rights will be affected and you may be entitled to a benefit.

The purpose of this Notice is to inform you of your rights in connection with the proposed settlements with Settling Defendants R.P. Martin Holdings Limited and Martin Brokers (UK) Ltd. (collectively, “R.P. Martin”), Citigroup Inc., Citibank N.A., Citibank Japan Ltd., and Citigroup Global Markets Japan Inc. (collectively, “Citi”), and HSBC Holdings plc and HSBC Bank plc (collectively, “HSBC”) in the actions titled Laydon v. Mizuho Bank Ltd. et al., 12-cv-3419 (GBD) (S.D.N.Y) and Sonterra Capital Master Fund, Ltd. et al. v. USB AG et al., 15-cv-5844 (GBD) (S.D.N.Y). The settlements with R.P. Martin, Citi, and HSBC (collectively, the “Settlements”) are not a settlement with any other Defendant and thus are not dispositive of any of Plaintiffs’ claims against remaining Defendants.

The Settlements have been proposed in a class action lawsuit concerning the alleged manipulation of the London Interbank Offered Rate for the Japanese Yen (“Yen-LIBOR”) and the Tokyo Interbank Offered Rate (“Euroyen TIBOR”) from January 1, 2006 through June 30, 2011, inclusive. The Settlements will provide $58 million to pay claims from persons who transacted in Euroyen-Based Derivatives from January 1, 2006 through June 30, 2011, inclusive. If you qualify, you may send in a Proof of Claim form to potentially get benefits, or you can exclude yourself from the Settlements, or object to them.

The United States District Court for the Southern District of New York (500 Pearl St., New York, NY 10007-1312) authorized this Notice. Before any money is paid, the Court will hold a Fairness Hearing to decide whether to approve the Settlements.

**Who Is Included?**

You are a “Settlement Class Member” if you purchased, sold, held, traded, or otherwise had any interest in any Euroyen-Based Derivatives at any time from January 1, 2006 through June 30, 2011, inclusive. Excluded from the Settlement Class are (i) Defendants and any parent, subsidiary, affiliate, or agent of any Defendant; (ii) the Released Parties; and (iii) any Class Member who files a timely and valid request for exclusion.

Contact your brokerage firm to see if you purchased, sold, or held Euroyen-Based Derivatives. If you are not sure you are included, you can get more information, including the Settlement Agreements, Mail Notice, Plan of Allocation, Proof of Claim and other important documents, at www.EuroyenSettlement.com (“Settlement Website”) or by calling toll free 1-866-217-4453.

**What Is This Litigation About?**

Plaintiffs allege that each Defendant, between January 1, 2006 through June 30, 2011, inclusive, manipulated or aided and abetted the manipulation of Yen-LIBOR and Euroyen TIBOR, and the prices of Euroyen-Based Derivatives. Defendants allegedly did so by using several means of manipulation. For example, panel banks that made the daily Yen-LIBOR and/or Euroyen TIBOR submissions to the British Bankers’ Association and Japanese Bankers Association (collectively, “Contributor Bank Defendants”), such as Citi and HSBC, allegedly falsely reported their cost of borrowing in order to financially benefit their Euroyen-Based Derivatives positions. Contributor Bank Defendants also requested that other Contributor Bank Defendants make false Yen-LIBOR and Euroyen TIBOR submissions on their behalf to benefit their Euroyen-Based Derivatives positions.

Plaintiffs further allege that inter-dealer brokers, intermediaries between buyers and sellers in the money markets and derivatives markets (the “Broker Defendants”), such as R.P. Martin, had knowledge of, and provided substantial assistance to, the Contributor Bank Defendants’ foregoing alleged manipulations of Euroyen-Based Derivatives in violation of 22(a)(1) of the Commodity Exchange Act, 7 U.S.C. § 25(a)(1). For example, Contributor Bank Defendants used the Broker Defendants to manipulate Yen-LIBOR, Euroyen TIBOR, and the prices of Euroyen-Based Derivatives by disseminating false “Suggested LIBORs,” publishing false market rates on broker screens, and publishing false bids and offers into the market.

Plaintiffs have asserted legal claims under various theories, including federal antitrust law, the Commodity Exchange Act, the Racketeering Influencing and Corrupt Organizations Act, and common law.

Citi, R.P. Martin, and HSBC have consistently and vigorously denied Plaintiffs’ allegations.

**What Do the Settlements Provide?**

Under the Settlements, Citi agreed to pay $23 million and HSBC agreed to pay $35 million into a Settlement Fund. If the Court approves the Settlements, potential payment will also be deducted from the Settlement Fund before any distributions are made to the Settlement Class.

The Court will hold a Fairness Hearing in these cases on November 10, 2016, to consider whether to approve the Settlements and a request by the lawyers representing all Settlement Class Members (Lowey Dannenberg Cohen & Hart, P.C.) for an award of attorneys’ fees of no more than one-fourth of the Settlement Fund for investigating the facts, litigating the case, and negotiating the settlement, and for reimbursement of their costs and expenses in the amount of no more than approximately $1,000,000. The lawyers for the Settlement Class may also seek additional reimbursement of fees, costs, and expenses in connection with services provided after the Fairness Hearing. These payments will also be deducted from the Settlement Fund before any distributions are made to the Settlement Class.

You may ask to appear at the Fairness Hearing, but you do not have to. For more information, call toll free 1-866-217-4453, visit the website www.EuroyenSettlement.com, and publishing false bids and offers into the market.

**How Do You Ask For a Payment?**

If you are a Settlement Class Member, you may seek to participate in the Settlements by submitting a Proof of Claim to the Settlement Administrator no later than January 24, 2017. You may obtain a Proof of Claim on the Settlement Website or by calling the toll-free number referenced above. If you are a Settlement Class Member but do not file a Proof of Claim, you will still be bound by the releases set forth in the Settlement Agreements if the Court enters an order approving the Settlement Agreements.

**What Are Your Other Options?**

All requests to be excluded from the Settlements must be made in accordance with the instructions set forth in the Settlement Notice and must be postmarked to the Settlement Administrator no later than October 6, 2016. The Settlement Notice, available at the Settlement Website, explains how to exclude yourself or object. If you exclude yourself from the Settlement Class, you will not be bound by the Settlement Agreements and can independently pursue claims at your own expense. However, if you exclude yourself, you will not be eligible to share in the Net Settlement Fund or otherwise participate in the Settlements.

The Court will hold a Fairness Hearing in these cases on November 10, 2016, to consider whether to approve the Settlements and a request by the lawyers representing all Settlement Class Members (Lowey Dannenberg Cohen & Hart, P.C.) for an award of attorneys’ fees of no more than one-fourth of the Settlement Fund for investigating the facts, litigating the case, and negotiating the settlement, and for reimbursement of their costs and expenses in the amount of no more than approximately $1,000,000. The lawyers for the Settlement Class may also seek additional reimbursement of fees, costs, and expenses in connection with services provided after the Fairness Hearing. These payments will also be deducted from the Settlement Fund before any distributions are made to the Settlement Class.

You may ask to appear at the Fairness Hearing, but you do not have to. For more information, call toll free 1-866-217-4453, visit the website www.EuroyenSettlement.com.